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## Wrong Diagnosis, Wrong Prescription

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# AVON HILLS SALON

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Thoughts from the Avon Hills

## *Louis Johnston on “Wrong Diagnosis, Wrong Prescription”*

DECEMBER 22, 2016

Louis Johnston

The Republican Party’s economic policy since World War II has rested on two key ideas: free trade and limited government involvement in picking industrial winners and losers.

Now, the incoming Trump administration promises a new path. According to the Financial Times, the administration will “create a National Trade Council inside the White House to oversee industrial policy and is appointing a China hawk and one of the architects of the populist economic message to run the new group.”

The result is a Republican president embracing Economic Nationalism, an idea that traces its lineage to Alexander Hamilton and his 1790 Report on the Subject of Manufactures. In particular, Economic Nationalism involves restricting a country’s international trade and using government policy to promote particular industries.

### Wrong diagnosis, wrong prescription

Trump’s campaign was a response to anger in the Rust Belt, and elsewhere, over the loss of good-paying manufacturing jobs. This decline has deep historical roots. In particular, rapid

productivity growth in manufacturing industries combined with slow growth in the demand for manufactured products means that these companies need fewer workers. Contrary to popular wisdom, American companies moving abroad for cheaper foreign workers contributed only slightly to this problem.

Trump and his supporters diagnose the illness differently. They believe that Republican economic orthodoxy led to the decline of American manufacturing and the disappearance of thousands of jobs in the industrial Midwest. In particular, they assert China, among other countries, has taken advantage of our free trade policies and lack of protection for domestic businesses to steal jobs and industries that should be ours. Trump's prescription is a strong dose of Economic Nationalism.

### Economic Nationalism and trade

Republican presidents since Eisenhower have promoted free and open international trade. To do this, they took two approaches. First, the US worked to develop multilateral institutions such as the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO). GATT and WTO functioned as forums in which nations worked together to lower tariffs and reduce trade barriers in the belief that free trade advanced them all. Economists generally agreed.

Second, the US negotiated directly with other countries to reach trade agreements, man-sewing with the North American Free Trade Agreement (NAFTA) and the Trans-Pacific Partnership (TPP) being the best known. Again, economists found that such deals benefitted the nations involved though the benefits have not been evenly distributed.

Trump clearly loathes both of these channels. He proposes unilaterally imposing 35-45 percent tariffs and renegotiating trade agreements such as NAFTA, though he has not provided specifics of either scheme. Both actions would violate WTO treaties.

Imposing high tariffs would probably start a trade war, with other countries raising their tariffs in retaliation. The Peterson Institute for International Economics has estimated the effects of various trade war scenarios: every simulation showed American output and employment falling, leading to decreased family incomes and higher rates of unemployment.

Furthermore, other countries might be willing to renegotiate trade agreements, but doing this opens up many issues that they might have with the US. Reopening NAFTA, for example, might lead to restrictions on agricultural trade which could harm American agribusiness. Overall, it seems likely that such renegotiations would harm the US economy more than help it.

### Economic Nationalism and industrial policy

The second facet of Economic Nationalism is industrial policy. Industrial policy consists of government efforts to promote particular industries. Paul Krugman provides a clear characterization:

*[Industrial Policy] may include general incentives for capital formation, R&D, retraining of labor, and so on, but it will also almost surely involve “targeting” of industries thought to be of particular importance. By targeting I mean an effort to change the allocation of investment – as opposed to its overall level – so as to favor particular industries in which the private market is believed to underinvest. There may be other concepts of targeted industrial policy, but the question of the **government’s role in the allocation of investment** is surely the most important and controversial one. [Emphasis added]*

Republicans traditionally recoiled from any role for government in directing resources toward certain industries, at least philosophically. They generally believed that financial markets did a good job allocating investment capital to where it was most productive, and that the idea of markets “underinvesting” in particular industries was nonsense. If an industry experienced declining investment spending, it was because that sector had worse economic prospects than did sectors receiving increased investment. Republicans have asserted there was nothing that government policy could do to improve the situation.

In practice, however, Republican administrations have engaged in defense-oriented industrial policies, for example, to support the 1980s military build-up in areas such as advanced aircraft design (such as stealth technology) and weapons development. Nonetheless, aside from a government led effort to promote general research and development in semiconductor technology (known as Sematech), national defense was deemed a one-of-a-kind situation, one in which it was too risky to let the market take time to find which producers and which technologies were best.

By contrast, Trump embraces industrial policy. He clearly has no problem using the bully pulpit to push companies to change their ways, as when he stated, “We’re gonna get Apple to start building their damn computers and things in this country, instead of in other countries.”

In addition to browbeating companies, Trump intends to use tax policy to support particular companies (e.g. tax incentives to Carrier to keep jobs in Indiana) and regulatory policy to assist entire industries (e.g. repealing Clean Air Act regulations to help the coal industry.)

We can see the likely results of industrial policy by examining how it has affected economies where it has been applied. For example, East Asian countries such as Korea, Taiwan, and more recently China used industrial policy extensively to catch up to American and European industries such as steel, textiles, and electronics.

There are two problems with following this prescription. First, the strategy works for low-income countries that are catching up with high income countries but not for already rich nations. Economists debate why this is the case, but hypotheses center around the difficulty of moving from a country that imports new technologies and grows quickly to an economy that must develop its own new technologies and grows more slowly.

Second, Alice Amsden, the leading scholar in this area, called the government structure that resulted from these policies a Development State, one in which tight links among

government officials and business management led to rapid industrial growth combined with deep corruption among those same managers and bureaucrats. This is what we usually think of as crony capitalism, something candidate Trump decried during the campaign, but which is likely to grow under the types of industrial policies he is expected to implement.

### Wrong diagnosis, wrong prescription

Trump and his supporters believe that Republican economic orthodoxy, aided by Democratic trade deals as well, led to the decline of American manufacturing and the disappearance of thousands of jobs in the industrial Midwest. The prescription for this ailment is Economic Nationalism.

This is the wrong diagnosis of what ails our economy. The resources and income in an economy are not created by business alone, and promoting and protecting American businesses will do little to bring back middle-class jobs.

To promote economic development and growth, government policy should target people and the markets in which they interact with one another, not companies. Economic policy should aim to ensure that Americans are well-educated and healthy and that all businesses, large, small, global, and local, have access to the private capital and public infrastructure they need to grow and thrive. And those particular locales and workers harmed by free trade should receive government aid to recover from such economic shocks.

Unfortunately, American voters chose economic quackery and the prospect of miracle cures on November 8, and we will all live with the consequences of that choice for years to come.

*I thank Susan Riley for extensive assistance with this essay.*